## PRINCIPAL STATUTES AND RULES INVOLVED

Section 2 (1) of the 1933 Act (15 U.S.C. 77b (1)) —

"Sec. 2. When used in this title, unless the context otherwise requires —

" (1) The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Section 3 (a) (8) of the 1933 Act (15 U.S.C. 77c (a) (8)) —

"Sec. 3 (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

• • •

" (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;"

Section 3 (a) (10) of the 1934 Act (15 U.S.C. 78c (a) (10)) —

"Sec. 3 (a) When used in this title, unless the context otherwise requires —

• • •

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Section 10 (b) of the 1934 Act, 15 U.S.C. 78j (b) —

"Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

* * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 of the Securities and Exchange Commission —

"Reg. §240.10b-5. It shall be unlawful for any person, directly or indirectly, by the use of any means or instru-

mentality of interstate commerce, or of the mails, or of any facility of any national securities exchange —

"(a) to employ any device, scheme, or artifice to defraud,

"(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." [Adopted in Release No. 34-3230, May 21, 1942, 13 F.R. 8177.]

McCarran-Ferguson Act, 15 U.S.C. 1012 —

"(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

"(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided*, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1944, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

Illinois Revised Statutes, Sec. 845 of Insurance Code —

"After the calendar year during which this code becomes effective, no Life company authorized to do business in this

State shall issue both participating and non-participating policies unless at least 90 percentum of the profits on its participating policies shall inure to the benefit of the participating policy-holders. Any company having in force both participating and non-participating policies shall keep a separate accounting for each class of business and shall make and include in the annual statement to be filed with the Director each year, a separate statement showing the gains, losses, and expenses properly attributable to each of such classes and also showing the manner in which any general outlay of expense of the company has been apportioned to each except that this provision shall not apply to any company in which 90 percentum or more of the business in force is either participating or non-participating. This section shall not apply to business done by such Life company outside this State, nor to paid-up, or temporary insurance or pure endowment benefits issued or granted pursuant to the non-forfeiture provision prescribed in Clause (g) of Sub-Section (1) of Section 2241 nor to annuities or policies of re-insurance." As amended by Act approved June 13, 1957.

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 75-3061

D. C. Docket No. CA 69-452

CHARLES L. GRAINGER, ET AL.,
*Plaintiffs-Appellants,*

versus

STATE SECURITY LIFE INSURANCE COMPANY, ET AL.,
*Defendants-Appellees.*

Appeal from the United States District Court for the Northern District of Alabama

Before GODBOLD, McCREE* and TJOFLAT, Circuit Judges.

## JUDGMENT

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Alabama, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, reversed in part and vacated in part, and that this cause be and the same is hereby remanded to the said District Court for further proceedings in accordance with the opinion of this Court;

It is further ordered that defendants-appellees pay to plaintiffs-appellants, the costs on appeal to be taxed by the Clerk of this Court.

February 18, 1977

Issued as Mandate:

*Of the Sixth Circuit, sitting by designation.

**CORRECTED**

Charles S. GRAINGER et al., on behalf of themselves and all other similarly situated Purchasers of "Variable Investment Plan" Contracts Issued and Sold by Great States Life Insurance Company, Plaintiffs-Appellants,

v.

STATE SECURITY LIFE INSURANCE COMPANY et al.,
Defendants-Appellees.

No. 75-3061.

United States Court of Appeals, Fifth Circuit.

Feb. 18, 1977.

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Appeal from the United States District Court for the Northern District of Alabama.

Before GODBOLD, McCREE,* and TJOFLAT, Circuit Judges.

GODBOLD, Circuit Judge:

This case involves the issue of whether contracts sold by an insurance company are "securities" for purposes of the Securities Acts of 1933 and 1934.[1] The district court held that as a matter of law the contracts were insurance and not securities and therefore were not within the purview of the Securities Acts, and entered a Rule 54 (b) judgment for defendants. Also the court denied the request of plaintiffs to certify a class consisting of all purchasers of the contracts. We reverse the judgment for defendants and vacate the refusal to certify the class.[1a]

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*Of the Sixth Circuit, sitting by designation.

[1] 15 U.S.C. §§ 77a-78kk.

[1a] This is a companion case to *Hilgeman v. National Insurance Company of America*, (CA5, 1977) No. 75-1724, slip opinion p. ——, —— F.2d ——, decided this date.

In the early 1960's Great States Insurance Company was marketing what it termed "Variable Investment Plan" contracts ("VIP contracts"). These contracts were, at least in form, similar to participating coupon policies.[2] The VIP contracts sold to plaintiffs allegedly incorporated as part of their terms a section of the Illinois insurance laws which required companies offering both participating and nonparticipating policies to keep separate accounts and to allocate 90% of their "profits" on their participating policies to the benefit of their participating policyholders.

Each named plaintiff purchased one or more VIP contracts. Later Great States adopted a drastically reduced scale of dividends on its VIP contracts. Plaintiffs brought a class action against State Security Life Insurance Company (the successor to Great States through a statutory merger), and L. M. Nimmo and Nimmo and Associates, Inc., as controlling persons of Great States, alleging: (a) violations of § 5 of the 1933 Act by the failure to register the VIP contracts; (b) violations of § 17 of the 1933 Act, and § 10(b) of the 1934 Act and Rule 10b-5 thereunder, 17 C.F.R.

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[2] A participating policy is "one in which dividends are paid to policyholders based upon company earnings, so that net cost is determined by deducting the amount of such dividends from the gross premiums." 1 J. Appleman & J. Appleman, Insurance Law and Practice, § 9 (1965).

The authors of this treatise go on to describe coupon policies in the following terms:

> "Coupon policies are usually considered to be nonparticipating in form, but, with the legal incidents usually attached thereto, they would seem properly to belong in the class of participating contracts. The rate is usually the same as for the latter group. The contract has inserted in it a sheet of coupons, one of which can be clipped each time a premium is paid. This may be sent to the company together with a remittance for the balance of the premium. The coupons often are graduated in amount, increasing in the same degree that ordinary dividends would increase, and interest is figured thereon at the company's regular rate.
>
> "Thus, it is usually considered that if the insured fails to clip such a coupon and instead sends the full amount of the premium to the company, he has elected to permit it to remain at interest, and no further action on his part is usually required."

*Id.* at § 10.

240.10b-5 (1976), in mailing material misrepresentations to buyers in connection with the sale of the VIP contracts; (c) common law fraud in connection with the sale of the VIP contracts; (d) breach of the VIP contract; and (e) violations of the anti-fraud and proxy provisions and rules of the 1934 Act and common law fraud, in connection with the 1968 merger between State Security and Great States.[3]

[1] Defendants filed motions to dismiss, to quash service of process and to block discovery. The court overruled the motion of State Security to dismiss the common law fraud and breach of contract claims against it. It also overruled all motions of defendants concerning the claims relating to the 1968 merger. The court granted the motions of Nimmo and Nimmo and Associates to dismiss the common law fraud and breach of contract claims stemming from the sale of the VIP contracts. None of these rulings have been appealed. Two rulings which the court made are now before us. First, it dismissed all federal Securities Act claims arising out of the sale of the VIP contracts against all three defendants on the ground that the contracts were not covered by the Acts because they were insurance contracts, and thus the plaintiffs had failed to state a claim upon which relief could be granted. The court, under Rule 54 (b), directed entry of judgment for the defendants on these federal Securities Acts claims. The court also denied plaintiffs' motion to certify a class consisting of VIP contract holders.[4]

[2] Generally, conventional life insurance policies are not securities for purposes of the federal Securities Acts. This view is supported by the legislative history of the 1933

[3]At least one of the plaintiffs was also a shareholder of Great States.

[4]The class determination is appealable under the general rule that "interlocutory orders from which no appeal lies are merged into the final judgment and open to review on appeal from that judgment." *Monarch Asphalt Sales Co., Inc. v. Wilshire Oil Co.*, 511 F.2d 1073, 1077 (CA10, 1975); 7A Wright & Miller, Federal Practice & Procedure § 1802 at 270 (1972).

Act,[5] by the leading commentators in the securities law field, L. Loss, *Securities Regulation*, 496-501 (1961); 2 A. Bromberg, *Securities Law: Fraud* § 6.5 (1) n. 92 at 134 (1968); and by dictum in the Supreme Court's decision in *Tcherepnin v. Knight*, 389 U.S. 332, 88 S.Ct. 548, 19 L.Ed. 2d 564 (1967).[6]

However, as Professor Loss has noted, the concept of insurance is really a continuum ranging from one year term insurance, which is clearly pure insurance, through variable annuities to mutual fund shares and common stocks, which are equally clearly securities. L. Loss, *Securities Regulation* 2534 (1969 Supp.). Thus, various items which have usually been denominated "insurance" have been found to be "securities" for purposes of the federal Securities Acts. For example, in *S.E.C. v. United Benefit Life Insurance Company*, 387 U.S. 202, 87 S.Ct. 1557, 18 L.Ed.2d 673 (1967), and *S.E.C. v. Variable Annuity Life Insurance Company*, 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959), the Supreme Court held that flexible fund or variable annuities are securities and are therefore subject to the provisions of the Securities Acts.[7]

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[5]In the House Report on the 1933 Act it was clearly stated that ". . . insurance policies are not to be regarded as securities subject to the provisions of the act." HR Rep. No. 85, 73rd Cong., 1st Sess. 15 (1933).

[6]In *Tcherepnin* the Court pointed out that Congress had specifically stated that " 'insurance policies are not to be regarded as securities subject to the provisions of the act . . and the exemption from registration for insurance policies was clearly supererogation.' " 389 U.S. at 342-43, n. 30, 88 S.Ct. at 556, 19 L.Ed.2d at 572-73, n. 30 [cites omitted].

Justice Brennan, in his concurring opinion in *S.E.C. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 79 S.Ct. 618, 3 L.Ed.2d 640 (1959), made virtually the same point when he said that "[u]nder the Securities Act, it would appear that in the case of the ordinary insurance policy, the exemption would be just comfirmatory of the policy's noncoverage under the definition of security." 359 U.S. at 74, n. 4, 79 S.Ct. at 623, 3 L.Ed.2d at 646, n. 4 [cites omitted].

[7]More recently the Securities and Exchange Commission has ruled that variable death benefit life insurance policies are also "securities." Securities Act Release No. 33-5360 Fed.Sec.L.Rep. [1972-73 Decisions] ¶ 79,207.

[3] The court below compared the VIP contracts with the policies involved in *Variable Annuity* and *United Benefit* and found the VIP contracts different because they provided for what the court termed a "significant" fixed death benefit of $10,000. The comparison of policies was proper, but the court could not stop at this point. In making a determination of what exactly was being offered by the Great States salesmen it was required to consider the methods used in selling the contracts.

In *S.E.C. v. Joiner Leasing Corp.*, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943) the Court held that in determining if an instrument is an investment contract, and therefore a security, "the terms of offer, the plan of distribution and the economic inducements held out to the prospect" were all relevant factors to be considered. 320 U.S. at 353, 64 S.Ct. at 124, 88 L.Ed. at 94. The Court went on to say that "[i]n the enforcement of an Act such as [the 1933 Act] it is not inappropriate that promoters' offerings be judged *as being what they were represented to be.*" *Id.* [emphasis added]. Numerous lower courts have correctly interpreted this language from *Joiner* as justifying a consideration of advertising and promotional efforts in ascertaining that items which intuitively would not seem to be securities are, in reality, securities within the meaning of the federal Acts, *e. g., Miller v. Central Chinchilla Group, Inc.*, 494 F.2d 414, 417 (CA8, 1974) (chinchillas); *Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d 1027, 1034-35 (CA2, 1974) (Scotch whisky receipts); *S.E.C. v. Brigadoon Scotch Distributors, Ltd.*, 388 F.Supp. 1288, 1290 (S.D. N.Y., 1975) (rare coins); *S.E.C. v. Haffenden-Rimar*, 362 F.Supp. 323, 325 (E.D.Va., 1973), *aff'd* 496 F.2d 1192 (CA4, 1974) (Scotch whisky). Indeed, the Supreme Court itself in *United Benefit* examined the advertising used to sell the "policies" at issue in making its determination that

the appellee was selling investment contracts and not insurance.[8]

[4] While the district court recognized the authority of *Joiner* and the subsequent "advertising" cases, it attempted to limit their scope by formulating a rule that advertising and promotional efforts can be used to determine the character of an instrument only where that instrument is not clear on its face. In essence, the district court read into the Securities Acts a parol evidence rule. We think that interpretation cannot be sustained. First, neither *Joiner* nor any of the lower court "advertising" cases (with one possible exception) make use of the parol evidence rule in determining whether an item is a security.[9] More important, however, use of a parol evidence rule leads a court to focus on the wrong question. The proper question before the district court was not "what is the correct interpretation of the VIP contracts?" but "what were defendants purporting to sell to plaintiffs?"[10] The parol evidence rule may have some application to the former question. It is not relevant to the latter question.[11] Therefore, the district court must

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[8]Speaking for a unanimous Court Justice Harlan noted that,

"United's primary advertisement for the 'Flexible Fund' was headed 'New Opportunity for Financial Growth.' United's sales aid kit included displays emphasizing the possibility of investment return and the experience of United's management in professional investing."

387 U.S. at 211, n. 15, 87 S.Ct. at 1562, 18 L.Ed. at 679, n. 15.

[9]The district court cited *Chapman v. Rudd Paint & Varnish*, 409 F.2d 635 (CA9, 1969), as authority for its use of the parol evidence rule. However, the language in *Chapman* concerning the consideration of promotional advertising is *dicta*, for the Ninth Circuit did in fact examine the relevant advertising material in making a determination that a franchise arrangement was not a security.

[10]*Cf. Goodman v. H. Hentz & Co.*, 265 F.Supp. 440, 444 (N.D.Ill., 1967) where sale of nonexistent securities was held to violate Rule 10b-5.

[11]Even if we were to hold that the parol evidence rule applied in the case before us, it still by its own terms would not operate to bar evidence of the oral representations made by Great States salesmen. First, plaintiffs' 10b-5 cause of action is a fraud-based cause of action. *Cf. Ernst and Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976). Tradi-

in making a determination of whether the VIP contracts were securities take into account all the circumstances attending the sale of the VIP contracts, including the provision of Illinois law allegedly incorporated into the contract.

[5] We also have substantial doubts about the significance which the district court attributed to the death benefit on the VIP contracts. The mere presence of a death benefit of $10,000, or for that matter any given dollar amount, cannot conclusively establish that the insurance features of a particular contract are not simply window dressing on what is essentially an investment contract. Consideration must be given not only to the amount of the death benefit but also to the relationship between the size of the death benefit and the size of "premium" payments. A showing that the "premiums" were disproportionately high (in terms of insurance industry norms) in relation to the amount of the death benefit would be persuasive evidence that the VIP contracts were not being bought and sold for their insurance features, *i. e.*, as insurance policies, but for their future "dividends," *i. e.*, as investment contracts.[12]

[6] The district court held that class action was not appropriate on the VIP contract fraud claims because the claims depended upon the particularized representations made to each class member. It is true that a class action is

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tionally, the parol evidence rule will not operate to exclude parol evidence introduced to show fraud. Restatement of Contracts § 238(b), (1932). Moreover, many of the words in the VIP contracts such as "dividend" and "investment" possess a variety of meanings, and, generally speaking, parol evidence is admissible for the purpose of interpreting ambiguous language in contracts. *Id.* at § 233.

[12]Data on premium/death benefit ratios in participating life policies can be found. For example, such data was gathered by the SEC in formulating its now-rescinded Rule 3c-4 and incorporated therein in the form of a minimum multiple scale. We do not express any view on the substance of that no longer operational rule. We mention it merely to point out the availability of relevant data.

usually inappropriate in a securities fraud case where oral misrepresentations are involved. As we said in *Simon v. Merrill Lynch, Pierce, Fenner and Smith*, 482 F.2d 880 at 882 (CA5, 1973):

> If there is any material variation in the representations made or in the degrees of reliance thereupon, a fraud case may be unsuited for treatment as a class action. *See* Rule 23. Advisory Committee's Official Note, 39 F.R.D. 98, 107 (1966). Thus, courts usually hold that an action based substantially, as here, on oral rather than written misrepresentations cannot be maintained as a class action.

However, as this quote indicates, the key concept in determining the propriety of class action treatment is the existence or nonexistence of material variations in the alleged misrepresentations. It is possible, although unlikely, that oral misrepresentations can be uniform, *e. g.*, through use of a standardized sales pitch by all the company's salesmen. Plaintiffs in the present case should be given the opportunity to demonstrate the existence and use of such a device. If plaintiffs cannot do this, then the district court may quite properly refuse to certify a class on the grounds that common questions of law or fact do not predominate.

We therefore vacate the denial of class status to VIP contract holders.

REVERSED in part, VACATED in part, and REMANDED for further proceedings.

Charles S. GRAINGER et al.,
Plaintiffs-Appellants,
v.
STATE SECURITY LIFE INSURANCE COMPANY et al.,
Defendants-Appellees.

No. 75-3061.

United States Court of Appeals, Fifth Circuit.

Nov. 17, 1977.

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Appeal from the United States District Court for the Northern District of Alabama.

Before BROWN, Chief Judge, and THORNBERRY, COLEMAN, GOLDBERG, AINSWORTH, GODBOLD, MORGAN, CLARK, RONEY, GEE, TJOFLAT, HILL and FAY, Circuit Judges.

BY THE COURT:

IT IS ORDERED by the court that the order entered on May 25, 1977, 5 Cir., 553 F.2d 1008, for a rehearing of this case en banc is hereby vacated, and the case is remanded to the panel.

JAMES C. HILL, Circuit Judge, dissenting.

ON PETITION FOR REHEARING

Before GODBOLD and TJOFLAT, Circuit Judges.*

PER CURIAM:

In their petition for rehearing appellees L. W. Nimmo and Nimmo & Associates, Inc., protest that our decision means that an endowment insurance policy containing what they describe as "a commonly used provision" for the pol-

*Former Circuit Judge McCree, a member of the original panel, did not participate in this decision.

icyholder's participating in surplus can be found to be a security by reason of methods used in its sale. This characterization of our decision is not correct. We did not hold that participating life insurance policies in general are securities or even that the particular contracts in this case are securities. What we have held is that the district court must consider, along with the provisions of the VIP contracts themselves, the totality of the circumstances surrounding their sale, including any oral representations made, in determining whether defendants were selling securities.

"Endowment policies" vary in their terms and provisions, and participation clauses differ also. In this instance, as pointed out in our opinion the contract in issue is named "Variable *Investment* Plan" (emphasis added). It purports to guarantee the purchaser "90% of divisible surplus earnings." Attached coupons physically resemble coupons often attached to bonds. Also, without indicating any views on the relationship between the size of the death benefit and the size of premium payments in the VIP contracts, we pointed out that this relationship is a proper factor for consideration by the district court (as opposed to the substantiality of the death benefit, considered in isolation) in determining whether the facial characteristics of the contracts plus the circumstances of their sale caused them to be securities.

The petition for rehearing is DENIED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 75-3061

CHARLES S. GRAINGER, ET AL.,
*Plaintiffs-Appellants,*

versus

STATE SECURITY LIFE INSURANCE COMPANY, ET AL.,
*Defendants-Appellees.*

Appeal from the United States District Court for the Northern District of Alabama

(Filed December 12, 1977)

Before BROWN, Chief Judge and THORNBERRY, COLEMAN, GOLDBERG, AINSWORTH, GODBOLD, MORGAN, CLARK, RONEY, GEE, TJOFLAT, HILL, and FAY, Circuit Judges.

BY THE COURT:

IT IS ORDERED that the petition for reconsideration of vacation of rehearing en banc filed by appellees, Leslie W. Nimmo and Nimmo and Associates, Inc., is DENIED.

ENTERED FOR THE COURT:

/s/ JOHN C. GODBOLD

UNITED STATES CIRCUIT JUDGE

In the United States District Court for the Northern District of Alabama, Southern Division

| | | |
|---|---|---|
| Charles S. Grainger, et al., *Plaintiffs.* | ) | |
| vs. | ) | Civil Action |
| | ) | No. 69-452 |
| State Security Life Insurance Company, et al., *Defendants.* | ) | |

**ORDER**

(Filed June 20, 1972)

The above-styled cause is presently under submission on the following motions filed in behalf of the respective parties hereto: (1) motion of defendant, State Security Life Insurance Co., to dismiss the complaint; (2) motions of defendants, L. W. Nimmo and Nimmo & Associates, Inc., to quash service of process or in the alternative to dismiss the complaint; (3) motion of defendant, State Security Life Insurance Co., to require plaintiffs to post security for costs; (4) motion of plaintiffs for an order determining that this suit may be maintained as a class action; and (5) motion of plaintiffs for an order requiring production of documents by defendants.

In the exercise of its discretion, the Court elects to treat the motion to dismiss filed in behalf of each defendant as a motion for summary judgment and to allow all parties 20 days from the date of this order within which to submit any affidavits or other documentary evidence which they may deem relevant to the disposition of the following issue:

whether the "Variable Investment Plan" contracts issued to plaintiffs by Great States Life Insurance Co. or its successor in interest, State Security Life Insurance Co., constitute "securities" within the ambit of § 2 (1) of the Securities Act of 1933, 15 U.S.C.A. § 77 (b) (1) (1971) or § 3 (10) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78 (c) (10) (1971).

All motions other than defendants' motions to dismiss will remain under submission pending resolution of the question raised on motion for summary judgment.

It is so ordered.

Done this 20th day of June, 1972.

SEYBOURN H. LYNNE
Chief Judge

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**ORDER***

(Filed June 5, 1975)

This cause has been before this Court on motions to dismiss, to quash, and for summary judgment. The Court has had the benefit of extensive briefs and learned oral arguments from counsel.

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* (Note to judgment of District Court: This action was brought as a two-fold complaint. The first counts are based on the sale of the participating life insurance policies issued by Great States Insurance Company. The latter counts are based on an allegedly misleading proxy statement issued by State Security Life Insurance Company, successor to Great States by a merger and which plaintiffs' claim was controlled by Mr. Nimmo. The District Court found that Mr. Nimmo was not in control of State Security nor was he a participant in any securities law violation (A-52-3); but it held that the claim of plaintiffs based on an alleged conspiracy was not subject to motion to dismiss. No final judgment was entered nor appeal taken from the order on these latter counts, which are discussed in Parts IIB and VB of the following memorandum opinion. Consequently, that part of the action was not before the Fifth Circuit and would not be brought before this Court for review.)

Upon consideration of the analyses of counsel, the Court is of the opinion that the attached memorandum prepared by its law clerk, E. Mabry Rogers, correctly states both the law and the facts on this complex action, and the Court wholly adopts it as its opinion. In conformity with such memorandum, which the Court deems to be of obviously superior quality in its exhaustive and analytical discussion of subtle issues advanced by ingenious counsel,

It is Ordered, Adjudged and Decreed by the Court that

(a) Plaintiffs' claims against all defendants based upon the theory that the "V.I.P." contracts are "securities" (Counts 1, 2, and 3 of the complaint), be and the same are hereby dismissed for failure to state a claim under the Securities Exchange Act of 1934, the Securities Act of 1933, or the Securities Act of Alabama. There is no just reason for delay in entering a final judgment as to this claim, so that the Clerk is hereby Ordered to enter final judgment hereon pursuant to F.R.Civ.P. 54 (b);

(b) Defendant State Security's motion to dismiss the breach of contract and common law fraud claims (Counts 4, 5, and 6 of the complaint), is overruled insofar as the simple failure to state a claim is involved;

(c) The motions of defendants Nimmo and Nimmo and Associates, Inc., to dismiss the common law fraud and breach of contract claims as to the "V.I.P." contracts are granted for failure to state a claim as to these defendants;

(d) The motions of all defendants to dismiss the counts alleging fraud, both of the common law and of the federal statutory varieties as to the 1968 merger, are overruled;

(e) The motions of defendants Nimmo and Nimmo and Associates, Inc., to quash as to the counts concerning the 1968 merger are overruled; and

(f) The motion of plaintiffs to certify a class as to the "V.I.P." contracts is overruled, since the common questions

of law do not predominate over the questions affecting individual members only. The Court reserves a ruling on the class allegations regarding the 1968 merger and requests counsel to develop the issue in due course.

Done this 5th day of June, 1975.

SEYBOURN H. LYNNE
Senior Judge

**MEMORANDUM**

(Filed June 5, 1975)

TO: Judge Seybourn H. Lynne

FROM: E. Mabry Rogers, Law Clerk

RE: Grainger v. State Security Life Insurance Co., Civil Action No. 69-452, Pending Motions

## I. PROCEEDINGS TO DATE.

On July 15, 1969, plaintiffs instituted this action on behalf of themselves and of the classes they purported to represent. In their complaint, they allege five basic causes of action:[1]

> (1) That defendant State Security Life Insurance Company ("State Security") conspired with defendants L. W. Nimmo ("Nimmo") and his corporation, Nimmo & Associates, Inc. ("Nimmo Inc."), to defraud Great States Life Insurance Co. ("Great States") and its public, minority shareholders by a scheme and conspiracy whereby Nimmo agreed to sell his stock, and the stock held by Nimmo, Inc., of Great States at a price far in excess of its market value (or book value) to State Security on the understanding that State Se-

[1]This characterization of the complaint is taken from the brief filed herein by plaintiffs on November 4, 1969.

curity would then be caused to merge with Great States. Thereby Great States and its minority shareholders would be obligated to assume the debt incurred to buy out Nimmo and Nimmo Inc. The cause of action here is predicated upon the Securities Exchange Act of 1934 ("1934 Act") and on Rule 10b-5 thereunder;

(2) Misrepresentations were made to purchasers of "V.I.P." contracts issued by Great States (and thereafter assumed by State Security pursuant to the merger), each of which contracts was a "security" as defined by federal law, either on its face or because of representations made to the buyers. This cause of action is predicated upon § 17(a) of the Securities Act of 1933 ("1933 Act"), § 10(b) of the 1934 Act, Rule 10b-5 thereunder, and upon the Alabama Securities Act, Tit. 53 §§ 28, 45, *Code of Alabama 1940* (Recomp. 1958) (1973 Cum. Supp.);

(3) The "V.I.P." contracts were not registered with the SEC prior to being offered to the public, as required by the 1933 Act;

(4) Assets of Great States were allegedly unlawfully diverted to Nimmo for his private benefit, to the damage of Great States stockholders and to the holders of Great States "V.I.P." contracts, a common law cause of action; and

(5) The defendants have breached the terms of the "V.I.P." contracts held by plaintiffs and are due to account for same.

Service of the complaint was accomplished upon State Security through the Superintendent of Insurance for Alabama. Service upon Nimmo and upon Nimmo, Inc., was accomplished by the United States Marshal in Springfield, Illinois.

On September 5, 1969, State Security filed two motions, a motion to dismiss, based upon 57 grounds, and a motion to require plaintiffs to post security for costs.

On September 29, 1969, Nimmo moved to dismiss or, alternatively, to quash service. Nimmo, Inc., filed a similar motion on the same date.

On September 30, 1969, plaintiffs filed a motion seeking production of various documents by the defendants.

On January 15, 1970, plaintiffs filed a motion for determination of both classes and for notice to the classes so determined.

On June 20, 1972, following disposition of the case of *Hilgeman v. Nat'l Ins. Co. of America,* 444 F.2d 446 (5th Cir. 1971), this Court entered an order treating the defendants' motions to dismiss as motions for summary judgment, and requesting counsel to direct their submissions to the disposition of the following issue:

> Whether the "Variable Investment Plan" contracts issued to plaintiffs by Great States Life Insurance Co. or its successor in interest, State Security Life Insurance Co., constitute "securities" within the ambit of § 2 (1) of the Securities Act of 1933, 15 U.S.C.A. § 77 (b) (1) (1971) or § 3 (1) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78 (c) (10) (1971).

All other motions were held in abeyance pending resolution of the issue above.

On September 5, 1974, the Court heard additional arguments directed to this issue.

On September 23, 1974, plaintiffs filed a motion for summary judgment in their behalf as to Counts 1 through 6. These counts encompass the claims as to fraud in the sale of the "V.I.P." contracts as securities and as to breach of the "V.I.P." contract itself.

In connection with the above proceedings, the Court has received affidavits from L. W. Nimmo (October 23, 1969),

Richard V. Moore, President of State Security (July 27, 1972), Lawrence A. Wadsworth, plaintiff (July 31, 1972), Charles S. Grainger, plaintiff (July 31, 1972), and James Williams Parsons, plaintiff (August 3, 1972). In addition, a transcript of the testimony of Marvin Henson, Jr., a plaintiff in this action who died on December 31, 1971, has been received (August 3, 1972). Moreover, depositions and documentary evidence have been received.

The Court has also had the benefit of numerous briefs of counsel in this case, the most recent of which include plaintiffs' brief of September 23, 1974, directed to the issue outlined above, and the reply brief from Nimmo and Nimmo Inc., of November 29, 1974.

Plaintiffs contend that because the "V.I.P." contracts were "securities" under the relevant federal securities provisions, jurisdiction and venue are good as to all defendants here. Additionally, they argue that because Nimmo and Nimmo Inc. were "controlling persons" of Great States at the time of its merger into State Security, jurisdiction as to them is also good under the 1934 Act.

The defendants, Nimmo and his company, argue that they were not "controlling persons" at the time of the merger, so that jurisdiction under the 1934 Act does not lie. Moreover, Nimmo and his company argue that the "V.I.P." contracts were not "securities" and that jurisdiction under the 1933 and 1934 Acts is therefore likewise defeated.

These matters are more appropriately resolved on motions for summary judgment rather than upon preliminary motions, since the intertwining of the merits with the jurisdictional issues warrants the consideration of more evidence than is usually appropriate to motions to dismiss.

## II. UNDERLYING FACTS.[2]

### A. The "V.I.P." Contracts.

In September, 1962, plaintiff Grainger was approached by two agents who are presumed to have been employed by Great States about purchasing a V.I.P. contract. They told him that they were selling an investment, not insurance. He was told that Great States would pay him and other buyers 90 per cent of the profits from the company. Grainger purchased, then and later, two and one-quarter "units"[3] from the salesmen.

Plaintiff Wadsworth bought his contract in October 1962. He was told

> that it was an "investment," that it would send my son through high school and college and pay all his expenses, that after he finished college it would pay him the income, that after the first few years the policy would take care of itself, and in case of my son's death, it would also pay $10,000.00 plus everything I had paid on it up to that point.

Plaintiff Henson, who is now deceased, was approached in September, 1962, about buying the contracts. He was specifically told that it was not insurance but was an investment on which he could make as much as 40 per cent interest.

Plaintiff Parsons was contacted in early 1963 about the purchase of an "investment policy" for his three-year-old son. He was given much the same glowing account of the dividend rate on his policy as were the other plaintiffs.

Each plaintiff received a similar "V.I.P." contract, a copy of which is in the record now before the Court.

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[2]These facts have been garnered from all submissions by all parties to date. Where relevant, differences in the submissions are noted.

[3]Grainger's affidavit states that "$10,000.00 is one unit," but this apparently refers to the face value of the insurance contract, not to its purchase price.

The contracts begin

> Great States Life Insurance Company of Quincy, Illinois, will pay the sum insured under the conditions hereof to the insured on the maturity date, if then living, provided all coupons hereon have been left with the company to accumulate at interest. Etc.

Mr. Grainger's contract shows a face-amount of $10,000.00, premium amount of $401.52, payable for ten years, and a maturity date of November 13, 1987. This kind of policy is characterized by State Security as an "Ordinary Life Coupon, Participating 25 Year Endowment Option with Coupon, Reduced Premium After 25 Years" policy. Its provisions will be developed more fully, *infra*.

Two particular features of the policy deserve mention here, however: The 90 per cent participation feature and the coupon feature.

As a part of the policy received by each plaintiff,[4] there was an excerpt from Illinois law which provided that

> No Life company . . . shall issue both participating and non-participating policies unless at least *90 percentum* of the profits on its participating policies shall *inure to the benefit* of the participating policy-holders. Any company having in force both participating and non-participating policies *shall keep a* separate accounting for each class of business. . . . [emphasis supplied, in part].[5]

According to Charles E. Miller, Manager of Great States in Alabama during the relevant period, this excerpt was included in the sales presentation made in connection with

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[4]Interestingly enough, neither of the "sample" policies tendered with affidavits submitted by the defendants contained this excerpt from the Illinois statutes.

[5]Although the law applied only to Illinois corporations, it was made a part of the contract by language to the effect that "V.I.P." policies in any state would be governed by the section.

the offer and sale of "V.I.P." contracts and was attached to every such contract sold in Alabama.

Also attached to the policies were twenty-four "Guaranteed Premium Reduction Coupons." These coupons guaranteed payment of stated amounts of cash by Great States to the insured upon surrender of the coupon. Provisions were also made for other, more attractive benefits, if the coupons were retained.

Additional evidence before the Court shows that Great States adopted, on August 28, 1962,[6] a dividend schedule which apparently approximated — very roughly[7] — a payout of 90 per cent of the company's profits on these policies. On July 1, 1966, a new dividend scale was proposed, and apparently accepted by Great States, distributing "about 50 per cent" of the profits to "V.I.P." contract holders. Rathbone Ltr., July 1, 1966. The actuary explained that this dividend change occurred because "[d]ividends for the early years were estimated rather high to attract new policy owners. Now that experience and cost for this block of business has been developed, a long-range dividend schedule is possible." Rathbone Ltr., March 16, 1967.

In a form letter sent to "V.I.P." policyholders who inquired about the dividend reduction, Great States explained that "[t]he reduction of this year's dividends for this policy series was recommended by our consulting actuaries and is

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[6]This was just prior to the purchases made by the named plaintiffs in this action.

[7]The evidence indicates that the Great States actuary constructed a dividend schedule which utilized "practically all the profits that might be expected from this contract . . . [leaving] little, if anything, for the stockholders." Tiffany Ltr., June 19, 1962. At the August 28, 1962, meeting of the Great States Board of Directors, Nimmo moved that dividends be set at the rate of 10 per cent below that suggested above. This may be viewed as a rough attempt at complying with the Illinois law cited as a part of the "V.I.P." contract, but it certainly does not seem to be an attempt to determine the 90 per cent payout by means of carefully segregated accounting entries, as required by that law.

due to an increased mortality experience along with the ever increasing costs of operations." The letter went on to report that "the dividend scale will increase in the years ahead."

In addition, the minutes of the Great States Board meeting of December 21, 1962, show a report "that the Alabama Commissioner [of Insurance] had instructed us [*i.e.*, Great States] to cease selling the VIP policy in that state." No apparent action was taken on this instruction. On August 1, 1963, the Commissioner, in a letter to Great States, requested that a representative from the company meet with the Commissioner, since policies of "a profit-sharing or investment nature" had not been approved for sale in Alabama. The results of this meeting do not appear.

It is apparent, however, from testimony taken in the case of *Henson v. State Security Life Ins. Co.*,[8] that the Commissioner, as late as August of 1967, had done little or nothing to contact holders of "V.I.P." policies regarding any action he had taken against Great States or its successor, State Security.

At present, State Security maintains a statutory reserve for the payment of benefits and obligations due under the V.I.P. policies. It does not, however, maintain separate accounting entries which make readily available the amount of profits derived from the V.I.P. contracts.[9]

B. The Merger.

From the time of its organization as an Illinois company in 1959, until August 31, 1968, Nimmo was formally and

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[8]The trial court directed a verdict on statute of limitations grounds. He was reversed in part, 288 Ala. 497, 262 So. 2d 745 (1972).

[9]This information is taken from plaintiffs' brief of September 23, 1974. For some reason, the answers to interrogatories which would show this information have apparently not been filed with the Court. *See F.R.Civ.P.* 5(d).

in fact active in the management of Great States. At all times prior to its merger into State Security, Nimmo and his company owned the controlling interest in Great States.

On June 13, 1967, Nimmo and Nimmo Inc., of which Nimmo was a 90 per cent shareholder, agreed to sell their controlling interest in Great States to State Security. The sale was of 763,049 shares of the 1,150,000 outstanding shares of Great States at a gross price of $2,098,384.75.[10] In return, Nimmo and his company agreed to deliver not only their stock, but also the written resignations of those members of the Great States Board of Directors requested by State Security. Moreover, Nimmo and his company promised that "[t]he Board of Directors of Great States [and another company not the subject of this lawsuit] prior to the closing of [the] Agreement shall execute an agreement of merger with Security and will further call a meeting of the respective shareholders of Great States [and the other company] to be held for the purpose of approving said agreement of merger."

On July 20, 1967, State Security wrote to Nimmo proposing to terminate the above agreement. Nimmo agreed to the termination.

On November 6, 1967, State Security filed a lawsuit against Nimmo and his company charging that the July 20, 1967, letter was a sham requested by Nimmo "to avoid appearing precommitted to a merger when dealing with the boards of directors of the companies involved." The complaint alleged that, despite the termination letter, Nimmo had agreed to effectuate the June 13, 1967, agreement. The

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[10]The purchase price was broken down into separate components: $270,000.00 for the 54,000 shares held by Nimmo Inc., or $5.00 per share; $1,828,384.75 for the 709,049 shares held by Nimmo, or approximately $2.60 per share.

suit was therefore predicated upon breach of the June agreement and upon fraud in its July recission.[11]

On May 10, 1968, State Security again contracted with Nimmo and Nimmo, Inc., to buy the 763,049 shares of Great States owned by them. The purchase price was now enhanced to $2,348,200.00.[12] Nimmo's 709,049 shares were assigned a value of $2,078,200.00, or about $2.93 per share. Nimmo, Inc.'s 54,000 shares were again assigned a value of $270,000.00, or $5.00 per share. On May 10, 1968, the market price of Great States, according to the plaintiffs, was approximately $1.13 per share.[13]

As part of this agreement, State Security agreed to hire Nimmo as a consultant for $30,000.00. Moreover, State Security agreed to have its action against Nimmo dismissed with prejudice, and the agreement recited that this was a part of the consideration paid to obtain Nimmo's acceptance of the agreement.

Paragraph five of this agreement required Nimmo to deliver "on or before August 28, 1968," the resignations of such members of the Great States Board of Directors as State Security should direct.

This sale was financed through payment by State Security of $992,657.02, apparently from its own assets. The additional $1,357,342.98 was apparently raised by sale of, or by outright transfer to Nimmo of, assets belonging to Great

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[11]In his deposition, Nimmo has testified that 90 per cent of the allegations in this complaint were untrue.

[12]There was an additional $1,200.00 paid for 266 shares of the common stock of Lincoln Life Ins. Co. of Arizona.

[13]The proxy statement sent out by Great States to its shareholders, in preparation for a September 20, 1968, meeting, reported that the high bid for Great States stock in 1968 was $2.50, while the low bid was $1.00.

According to plaintiffs, the book value of Great States stock was $.94 per share, and the adjusted book value was $2.09 per share.

States.[14] How the $992,657.02 in cash was to be raised is unclear; it is inferable that the sales agreement required only that by August 28, 1968, State Security would deliver to Nimmo and his company $992,657.02. A subsequent agreement reveals that State Security, jointly with Dependable Life Insurance Company, an Alabama insurance company,[15] executed to Nimmo a note for $873,667.98. The implication is that Nimmo and his company therefore received $118,989.04 in cash on August 28, 1968.[16]

Following this agreement, Great States issued a Notice of Meeting of Stockholders and a Proxy Statement, under date of August 8, 1968. The notice was signed by Nimmo. It reported that the meeting was called to elect directors and transact other business. A natural inference from this notice is that this election was related to Nimmo's promise in the sales agreement to deliver the resignations of the then-governing Board of Great States.

There were seven men nominated for the seven available Board positions. Of these, at least four were employees or directors of State Security.[17] The connection of nominees, A. Lamar Reid, Charles Butz, and Everett W. McClure, does not appear, although Mr. Reid's law firm in Birmingham, Alabama, was serving "of counsel" for State Security as of November 6, 1967.

The proxy statement revealed Nimmo's controlling interest and his sale of that interest effective on August 28,

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[14]Paragraph 10 of the Sales Agreement. *See also* the Escrow Agreement, tendered as Plaintiffs' Exhibit 21 to the most recent briefs on summary judgment. *See also* fn. 18, *infra*.

[15]A merger of Dependable (of Mobile, Alabama) into State Security was approved by all involved shareholders as of August 12, 1968.

[16]The plaintiffs' statement that only $25,000.00 in cash was paid to Nimmo before August 28, 1968, seems to be in error. It is perhaps derived from the aborted agreement of June 13, 1967.

[17]The proxy statement revealed the connections of three of them to State Security. It did not show that nominee Wittenberg was a Director of State Security.

1968. It also included the sales agreement and the escrow agreement between State Security and Nimmo.

The statement directs its readers' attention to the sales agreement and states that it shows that

> The net cash payment for control stock of [Great States] will be approximately $1,500,000.00, which [State Security] has said it would borrow pending completion of a merger with [Great States].

It is difficult to discern how the sales agreement provides any such thing.[18]

The statement also announces State Security's intention to merge with Great States upon completion of the Nimmo sale. It then states, "[n]either L. W. Nimmo or Nimmo and Associates, Inc., is party to the proposed merger, nor has either party participated in the planning of such merger."

The notice established the meeting date as August 28, 1968, but it was not held until August 30, 1968, for un-

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[18] *See* text accompanying Fn 14, *supra*.

This statement may be explained by combining the sale contract, the escrow agreement and the August 8 proxy statement. Under the sales agreement Nimmo was to have Great States sell, at stated minimum prices, the Great States office property, bonds of Putnam Dye Co., stock of the Horace Mann Life Ins. Co., and stock of the Life Assurance Co. of the West. If the minimum disposition prices of these assets are added to the amount State Security was to pay the escrow agent — $992,657.02 — the total equals the sales price of $2,350,000.00. On page 5 of the August 8 proxy statement, it is reported that Great States had disposed of the Horace Mann stock. If the contract minimum for this stock — $507,675.00 — is added to the amount State Security was to pay the escrow agent, the total is "approximately $1,500,000.00."

If this is the correct explanation of the transactions involved, it seems clear that part of the consideration paid Nimmo reflected these properties; in a sense they were transferred to him at the stated values. Since the values stated in the sales contract were inflated (Nimmo's Deposition, p. 127), Nimmo actually received less for his shares than is reflected in the raw sales price.

Regardless of the explanation of the above figures, plaintiffs have not complained about them nor do plaintiffs indicate how such figures may relate to their alleged causes of action.

explained reasons.[19] Immediately thereafter, the new Board met and adopted an agreement of merger between Great States and State Security, dated August 28, 1968.

Curiously enough, this agreement was signed for Great States by A. Lamar Reid, as President, although he was not elected President until August 30, 1968. In fact, on the date of the agreement, Nimmo, according to his affidavit filed herein, was still a director of Great States.

On August 28, 1968, A. Lamar Reid, as President of Great States,[20] issued a notice of a special meeting of the shareholders of Great States to be held on September 20, 1968. This meeting was called to vote upon the merger agreement between Great States and State Security. The proposed merger provided for an exchange of the stock of Great States for that of State Security at a ratio of 1.5 to 1. Great States management recommended, on page two, that the merger be approved; on page one, it was stated that the present Great States management "are persons nominated by Security. . . ."

This merger was approved by the shareholders, and the merger was consummated.

Plaintiffs contend that both the August 8 and the August 28 proxy statements were misleading. They also contend that the net result of the sale by Nimmo and the subsequent merger was Nimmo's receipt of an unjustified premium for his control of Great States and the minority shareholder's receipt of grossly devalued stock of State Security in return for their stock in Great States.

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[19]So long as the meeting was held on or after August 28, 1968, State Security would vote Nimmo's stock, pursuant to the proxy agreement included in Paragraph 20 of the May 10, 1968, agreement.

[20]This involves the same "curiosity" as that involved in his signature on the agreement. These acts by Mr. Reid were ratified on behalf of Great States by the newly-elected board on September 30, 1968.

## III. ISSUES PRESENTED.

There are a number of complex issues involved in the foregoing statement of facts. However, despite the numerous allegations tossed around by the plaintiffs, defendants are essentially correct in narrowing their focus to the issues involving the propriety of the service obtained in this case. This issue is particularly relevant to Nimmo and his company since they have been called before this Court under the long-arm provisions of the national securities acts.

As the Court's order of June 20, 1972, indicates, the question whether the "V.I.P." contracts are "securities" is appropriately addressed on more evidence than is normally available upon motions to quash. Since the merits of the issue are so intertwined with the jurisdictional issues, summary judgment is a more appropriate vehicle for resolution of the question. If, for example, it is found that the "V.I.P." contract is not a security, then, insofar as that issue is concerned, Nimmo's and his company's motion to quash are due to be granted, while State Security's motion to dismiss for failure to state a claim would also be due to be granted.

This memorandum, however, addresses the further issue — not raised in the June 20, 1972, order, but briefed by the parties — of the alleged fraud in regard to the 1968 sale of Nimmo's stock to State Security. The latter issue must be reached if the Court is to explore all jurisdictional bases at this time.

With the foregoing in mind, this memorandum considers the following issues:

(1) Does this Court have jurisdiction over Nimmo under the 1933 or 1934 Acts?

(a) On its face, is the "V.I.P." contract a "security" under either Act?

(b) If not, did the manner of sale of these contracts transform them into securities?

(2) Are there any other jurisdictional bases upon which this Court may hold Nimmo accountable with regard to these contracts?

(3) Has a cause of action been stated as to the 1968 merger of Great States into State Security?

(4) Is jurisdiction over Nimmo and his company proper as to the counts involving the 1968 merger?

(a) Was either defendant a "controlling" person of the entities perpetrating the alleged frauds?

(b) May the defendants be held under a conspiracy theory?

## IV. CONCLUSIONS.

It is concluded herein that the "V.I.P." contracts are insurance contracts, exempt from the 1933 and 1934 Acts. It is further concluded that plaintiffs have stated a cause of action against all defendants as to the 1968 merger, so that the Court has personal jurisdiction over all defendants.

## V. DISCUSSION.

As stated above, the plaintiffs contend that the "V.I.P." contract is a security under the 1933 and 1934 Acts, while defendants say it is merely a contract of insurance.

If plaintiffs are correct, then this Court has jurisdiction — both personal and subject matter — over the defendants under the jurisdictional provisions of the 1933 and 1934 Acts. Section 22 (a) of the 1933 Act, 15 U.S.C. § 77v (a) (1970), provides:

> The district courts of the United States . . . shall have jurisdiction . . . of all . . . actions at law brought to enforce any liability or duty created by this [act]. Any such suit or action may be brought in the district where the offer or sale took place, if the defendant par-

> ticipated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

Section 27 of the 1934 Act, 15 U.S.C. § 78aa (1970), provides:

> The district courts of the United States . . . shall have exclusive jurisdiction . . . of all . . . actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. . . . Any [such] action . . . may be brought in [the district wherein any act or transaction constituting the violation occurred] or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

Since liabilities and duties under both acts hinge upon the presence of a "security," it is clear that if the "V.I.P." contracts are not securities, then this Court does not have subject-matter jurisdiction over this suit under the above provisions. Moreover, service of process upon defendants Nimmo and his company would not be proper under the provisions.

Section 3 (a) of the 1933 Act, 15 U.S.C. § 77c (a), makes certain exemptions:

> Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of *securities*:
>
> * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia [.] [emphasis supplied]

There is no similar exemption from the 1934 Act; moreover, sections 12 (2) and 17 (c) of the 1933 Act, 15 U.S.C. §§ 771 (2), 77q (c) (1970), expressly provide that the exemptions of section 3 do not apply to the anti-fraud provisions of the 1933 Act.

Seizing upon these features of the two acts, plaintiffs contend that the 1934 Act, especially Section 10 (b) thereof, 15 U.S.C. § 78j (b) (1970), and the anti-fraud provisions of the 1933 Act apply to insurance contracts. They argue that Section 3, because of its reference to "the following classes of securities," treats insurance contracts as securities. It follows, therefore, that the above anti-fraud provisions and the 1934 Act apply to insurance contracts because they are "securities."

The plaintiff's argument is persuasive if only the language of the two acts is considered. However, Professor Loss provides the following explanation of the § 3 (a) (8) exemption:

> Section 3 (a) (8) of the Securities Act exempts "any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."
>
> This is a perfect example of how it sometimes does not pay to be too cautious. Without this exemption, and without any specific reference to insurance policies in the definition of "security," and at a time when *Paul v. Virginia* [8 Wall. 168 (U.S. 1869)] was still the law of the land, it is hardly conceivable that Congress would have subjected insurance policies to federal control *sub silentio*, even control which was merely of the disclosure variety. As it is, § 3 (a) (8) seems on its face to create a negative implication that insurance policies *are* securities, which may be exempt from

> the registration requirements but are subject to the antifraud provisions. Nevertheless, the Commission has taken the position that insurance or endowment policies or annuity contracts issued by regularly constituted insurance companies were not intended to be securities, and that in effect § 3 (a) (8) is supererogation. This undoubtedly carries out the legislative intention; for the House report states that the purpose of the exemption "makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act." 1 Loss, *Securities Regulation* 497 (2d ed. 1961) (footnotes omitted).

Professor Loss's analysis has been cited with approval by the Supreme Court in *Tcherepnin v. Knight*, 389 U.S. 332, 342 n. 30 (1967). The Court stated, moreover:

> Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the act," and the exemption from registration for insurance policies was clearly supererogation. *Id.* [citations omitted].[21]

Since the definition of "security" found in section 3 (a) (10) of the 1934 Act, 15 U.S.C. § 78c (a) (10), is virtually identical to that in section 2 (1) of the 1933 Act, 15 U.S.C. § 77 (b) (1), it seems reasonable that Congress intended to exclude insurance contracts from the 1934 Act as we have seen it did with regard to the 1933 Act.[22] Therefore, the

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[21] *See also S.E.C. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 98 (1959) (Harlan, J., dissenting).

Plaintiffs argue that *S.E.C. v. National Securities, Inc.*, 393 U.S. 453 (1969), supports their contention. That case, however, held that the federal securities acts applied to relationships between an insurance company and its stockholders, while saying nothing about whether insurance policies are "securities."

[22] Plaintiffs also argue that the § 3 (a) (8) exemption be construed narrowly to apply only to "pure 'risk' insurance contracts." This argument falls before the same legislative intent rehearsed above.

issue is whether the "V.I.P." contract is an insurance policy or some breed of security.

"Insurance" is a mercurial term, describing a myriad of contractual relationships and constantly expanding as new risks are created by the activities, and the changing perceptions of value attendant thereto, of men. Any attempt to define the term strictly is certain to fail. Insurance often entails an investment feature as well as an assumption of risk feature; when the assumptive feature becomes secondary to the investment feature, the insurance assumes more and more the attributes of a security. As Professor Loss has indicated:

> In the last analysis, there is no escaping the fact that there is a continuous spectrum from a one-year term life insurance policy, which is pure insurance, through the various forms of straight life and endowment policies, to the annuities, both fixed and (in varying degrees) variable, to mutual fund shares and ultimately common stock, which represent pure investment. 4 Loss, *Securities Regulation* 2534 (1969 Supp. to 2d ed.).

The Supreme Court has twice attempted to provide points for drawing the line between insurance contracts, which are exempt from the federal securities acts, and securities, which are not, in *S.E.C. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) ["VALIC"] and *S.E.C. v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) ["UBLIC"].

In *VALIC*, the Court considered whether variable annuity contracts, issued by insurance companies regulated by the insurance commissioners of a number of states (including Alabama), were exempt from the disclosure provisions of the 1933 Act, 15 U.S.C. § 77a, and from compliance with the Investment Company Act of 1940, 15 U.S.C. § 80a. The contracts in question included certain conven-

tional insurance features: declining term insurance for the first five years of pay-in, disability waiver of premium, and, most significantly, the assumption by the company of the entire risk of longevity.[23] These provisions, however, were deemed incidental to the primary form of the investment, which called for participation by the insured on a per-unit basis, in the entire portfolio of the company. The company's obligation, then, was always stated in terms of the present condition of its investment portfolio, not in terms of dollars.

Finding no guarantee of fixed income, the Court concluded that "the variable annuity places all the investment risks on the annuitant, none on the company." *Id.*, at 71. Concurring for himself and Justice Stewart, Justice Brennan provided a more detailed analysis of the risks assumed by the company during the pay-in period of the policy:

> The contract uses insurance terminology throughout and many of the common features of life insurance and annuity policies are operative in regard to it at this "pay-in" stage. There are "incontestability" and "suicide" clauses (which mainly relate to the term insurance); a "grace period" allowed for the payment of premiums; a provision for "policy loans" (the drawing down of accumulated units in cash, subject to replacement later to the extent that repayment of the amount of money received will then permit, the transaction bearing a resemblance to the liquidation by a common stock investor of his holdings in anticipation of a "bear market"); and provision for a "cash value" (that is,

[23]This means that, upon reaching the maturity date, the insured's interest in the general fund would be evaluated in terms of the amount paid in by the insured, as a function of a standard annuity table. This figure is then used to determine the number of "annuity units" to be paid the insured. Although the actual amount paid the insured would fluctuate every month with the value of the fund, he would receive the value of his annuity units every month, regardless of how long he lived. Thus, if the company had a "poor" longevity experience, compared to the actuarial predictions, it stood to lose substantially.

> for the cashing in of the accumulated units, subject to a surrender charge in the early years). And very certainly the commitment of the company eventually to disburse the accumulated values on a life annuity basis once the pay-in period is over is present throughout this period. But what the investor is participating in during this period, despite its acknowledged "insurance" features, is something quite similar to a conventional open-end management investment company, under a periodic investment plan. The investor's cash (less a charge analogous to a loading charge, which is, at least in the early years, very high, but which it should be said, has to cover annuity premium taxes and some quite conventional mortality risks) goes to buy "units" in a portfolio managed by the persons in control of the corporation. His "units" fluctuate with the income and capital gain and loss experience of the management of the portfolio. He may cash them in, wholly or partially. The amount of his equity is subjected to a charge, on asset value, of 1.8% per annum. Except for the temporary term insurance and the waiver of premium coverage, the entire nature of the company's obligation to its investor during this period is not in dollars (though of course it will be converted into them, just as a commodity transaction can be), but solely in terms of the value of its portfolio. 359 U.S. at 84-5.

It may be seen then, that the insureds in *VALIC* were buying into a fund, with the prospect of reaping the benefits of profitable management of the fund. There was simply no fixed dollar risk on the insurer nor any basis for a concommitant expectation by the insured. Under these conditions, the Court held that the investment contracts were not exempt from either the 1933 Act or the Investment Company Act of 1940.

Eight years later, the Court addressed the question once again in *UBLIC*, with Justice Harlan, a dissenter in *VALIC*, writing for a unanimous Court. In *UBLIC*, an

established, old-line insurance company offered an investment contract with bifurcated interests. The plan, called a "Flexible Fund," provided, during the pay-in period, for the insured's *pro rata* participation in a general investment fund. At the same time, he was guaranteed a minimum dollar amount, called the net premium guarantee. At maturity, the insured could elect various conventional annuity plans, none of which were dependent upon the value of the pooled funds of all insureds, as was the case in *VALIC*. Addressing only the first half of this scheme, the Court determined that the guaranteed dollar value associated with the pay-in period was "substantially less than that guaranteed by the same premiums in a conventional deferred annuity plan," 387 U.S. at 208. Thus, although there was some slight shifting of risk from insured to insurer, the basic framework of the pay-in period rested upon the same kind of investment fund which the Court had faced in *VALIC*. The Court thus held that the pay-in portion of the "Flexible Fund" contracts were not exempt insurance contracts and were therefore subject to the disclosure provisions of the 1933 Act.

The insurance contract at issue in the present case does not promise its holders that the amount of insurance they are purchasing is contingent upon how well a general fund is invested. Instead, the insureds are promised a fixed amount of insurance each year, and fixed options at the end of 10 years and 25 years. The insurance promised is not set at the illusory levels held to be tantamount to no insurance in *UBLIC*.

Plaintiffs also attack the following participating provision of the contracts:

> The proportion of divisible surplus accruing upon this policy shall be ascertained annually by the company.

> Beginning at the end of the second policy year, and on each anniversary thereafter, such surplus as shall have been apportioned by the company to this policy shall be available under any of the following options, upon written request by the person having control of this policy: (1) applied toward payment of renewal premiums; or (2) applied to purchase participating paid-up additional insurance payable under the same terms and conditions as this policy; or (3) left with the company to accumulate at interest at a rate of not less than 2½% per annum compounded annually; or (4) paid in cash. Outstanding dividend accumulations may be withdrawn in cash or shall be payable at the maturity of this policy to the person or persons entitled to its proceeds. If no option is selected, such divisible surplus will be paid in cash.

This provision is unlike the fund created in *UBLIC*, which, as has been noted, created insurance as a non-guaranteed portion of an investment fund. In the Great States contract, on the other hand, the participating feature is in addition to a *bona fide* insurance scheme and may be viewed as a reduction of premium. *VALIC*, 359 U.S. at 90 (Brennan, J., concurring).

Similar participating features are common in the insurance industry, 43 Am. Jur. 2d, *Insurance* § 120, pp. 177-8 (1969); 44 C.J.S., *Insurance* § 103, pp. 639-41 (1945); 1 Appleman, *Insurance Law and Practice* § 9 (Rev. ed. 1965), and they reflect the investment experience of the company, mortality savings, and savings in administrative costs. In the Great States policy, the participating feature is denominated as a "dividend," not as a "security" or as an ascertainable share of an investment fund. This feature, then, is not separable from the indisputably insurance aspects of the contract, and it is not a "security." Thus, it does not remove the "V.I.P." contract from the insurance

exemptions of the 1933 and 1934 Acts.[24] *Cf. Olpin v. Ideal National Ins. Co.*, 419 F.2d 1250 (10th Cir. 1969).

Plaintiffs argue that the coupons attached to the "V.I.P." policy are additional evidence that the policy is a "security" and not an insurance contract. This contention is unpersuasive.

The coupons provide:

> Subject to the provisions of [this] policy . . . and upon the payment of 2nd annual premium in full and not otherwise, Great States Life Insurance Company will pay to the order of the insured under said policy [a stated sum] or upon written request of the insured within thirty-one days after said date will apply said sum to the purchase of a paid-up life addition of [a stated sum].

The sum to be paid to the insured under the sample policy ($249.30) remains the same every year, while the amount of additional insurance which may be purchased declines by $30.00 each year. Various inducements are offered to the insured to refrain from cashing in his coupons, and each of them is plainly stated in the initial page of the contract. Such coupon policies are not widely used, but they are a standard form of insurance. 1 Appleman, *supra*, § 10. In effect the coupons are a guaranteed dividend, or rebate of premium. They are not premised upon a share in an investment pool and in no way represent a "security."

Their presence on an insurance policy, of course, may lend themselves to abuse, since the coupons might be compared to those on a bond, for example. The Insurance

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[24]This conclusion is reinforced by Judge McFadden's similar conclusion in *Hilgeman v. National Insurance Co. of America*, 1970 CCH Fed. Sec. L.Rep. ¶ 92,647 (N.D. Ala., April 22, 1970), *rev'd* 444 F.2d 446 (5th Cir. 1971). However, because of the confusing aspects and the ambiguous language of the Fifth Circuit in that case, no reliance is explicitly placed upon it.

Commissioner of Alabama apparently objected to the policies on this basis, as have other state commissioners. 1 Appleman, *id.* However, this fact does not change the exempt status of these insurance policies; rather it confirms the Congressional choice, embodied in the insurance exemption, to leave the regulation of insurance and its sale to the states. *Cf. VALIC*, 359 U.S. at 75 (Brennan, J., concurring).

The plaintiffs argue furthermore that these policies are transformed into "securities" because of the inclusion in each policy of a statutory provision drawn from Illinois law. The provision, as it appeared in the policy, is included in the statement of facts of this memorandum. While it is certain that this provision, like the coupons, may lend itself to abuse in the hands of unscrupulous salesmen, it does not change the character of the contract from one of insurance to an investment contract which is not exempt from the 1933 and 1934 Acts. The excerpt provides that at least 90 percent of the profits derived from participating policies shall inure to the benefit of the participants. To facilitate enforcement of this provision, a company issuing both participating and non-participating policies is enjoined to keep a separate accounting of the profits derived from the different types of policies. It is undisputed that Great States (and State Security) failed to keep this separate accounting. It is further undisputed that Great States lowered its dividends to its participating policy-holders in 1967. None of these facts changes the character of the risk assumed by the insurance company nor the kind of contract which the insured bought. The "V.I.P." contract is still insurance.

Plaintiffs also present a welter of information regarding the sales pitch given each plaintiff regarding the "V.I.P." contracts. The plaintiffs argue that these facts should be considered in determining whether the "V.I.P." contracts

were securities. They rely upon the Supreme Court's language in its seminal decision of *S.E.C. v. Joiner Corp.*, 320 U.S. 344, 351 (1943):

> In the Securities Act the term "security" was defined to include by name or description many documents in which there is common trading or speculation or investment. Some, such as notes, bonds, and stocks, are pretty much standardized and the name alone carries well-settled meaning. Others are of more variable character and were necessarily designated by more descriptive terms, such as "transferable share," "investment contract," and "in general any interest or instrument commonly known as a security." We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.' " The proof here seems clear that these defendants' offers brought their instruments within these terms.

The Court concluded its opinion by noting that in order to prove a document a "security," it might be necessary, as was done in *Joiner* to "go outside the instrument itself. . . ." *Id.*, at 355.

*Joiner*, however, involved the sale by defendant of leaseholds in small parcels of land in Texas to purchasers scattered around the nation. The evidence aside from the leases themselves indicated that woven into the sale of the leasehold was an assurance that the seller would under-

take to drill a well which might enhance the value of all the nearby leaseholds. Thus, the additional evidence there indicated that the buyers were purchasing not a leasehold but an agreement to drill a well. The proof showed that the buyers were investing in the efforts of another with an expectation of profit from the other's efforts.

On the other hand, none of the evidence brought forth by plaintiffs here remotely suggests such a relationship. At most, plaintiffs indicate that the salesmen treated the "V.I.P." insurance contract as if it were a "security."[25] These facts would tend to show common law fraud in the sale of the insurance contract, but they would not transform the nature of the contract itself. The insurance nature of this contract is plain and substantial on the face of the document, and the plaintiff has failed to show how the evidence outside the document would change its essential nature. *See Chapman v. Rudd Paint & Varnish Co.*, 409 F.2d 635, 640-1 and n. 5 (9th Cir. 1969); *cf. S.E.C. v. W. J. Howey Co.*, 328 U.S. 293 (1946).[26]

At this point, it is clear that there is no personal jurisdiction over Nimmo or his company on this claim under the securities act long-arm statutes. Service as to them should therefore be quashed as to all counts relying upon the "V.I.P." contracts. The Court should, in light of the second part of this memorandum, also dismiss as to this count for failure to state a cause of action against these two defendants.

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[25]Plaintiffs underscore the use of the word "investment" in the contract and in the sales pitch. Although this term is subject to much abuse, it seems indisputable that insurance is usually a form of "investment." *See VALIC, supra*, 359 U.S. at 75 (Brennan, J., concurring). Use of this term hardly warrants a finding that the contract here in issue was a "security."

[26]The same conclusion must be reached as to a cause of action under the Alabama Securities Act, Tit. 53 §§ 28, 45, *Code of Alabama 1940* (Recomp. 1958) (1973 Cum. Supp.), since that act likewise does not encompass causes of action based upon *bona fide* insurance contracts.

The situation is different as to State Security. It was served through the Superintendent of Insurance of Alabama. Personal jurisdiction is therefore established. Subject matter jurisdiction is predicated not only upon the Securities Acts, but also upon diversity of citizenship. Therefore, the quashing of service as to the Nimmo group does not require similar treatment of State Security, assuming there are causes of action alleged aside from those dealing with breaches of the securities acts.

Plaintiffs have alleged causes of action sounding in common law fraud and breach of contract. As to the former, the affidavits filed by the plaintiffs indicate that there are material and substantial factual contentions upon which a cause of action in fraud may be grounded. The admission of all defendants that the profits from the participating policies were never kept separate indicates a substantial breach of contract claim and may entitle plaintiffs to an accounting from State Security.[27]

Note, however, that neither Nimmo nor Nimmo Inc., as officers or shareholders of Great States, are personally liable for the fraud or breach of contract claims. Neither is alleged to have participated in the sales pitches given to the individual plaintiff-buyers. And the corporate structure shields them from the alleged breach of contract. Therefore, these claims, likewise, must be dismissed as to them for failure to state a cause of action.

This disposition, however, likewise precludes a class action as to either of these claims. The fraud claims each depend upon the particularized representations made to each plaintiff. The contract claim depends upon whether the

[27]This is a conclusion only as to whether a cause of action has been stated. It is not intended to preclude the defendant's raising defenses, such as statute of limitations, by way of answer or motion for summary judgment. Nor is this intended to establish that State Security must answer for torts allegedly committed by Great States or its agents.

excerpt from Illinois law was included in each plaintiff's insurance contract; since there is evidence in Mr. Nimmo's deposition that it was not the company's practice to include the excerpt in the policies, it would be inappropriate to assume that every class member received it as a part of his contract.

Under these circumstances, a class action may not be maintained as to the two claims on the "V.I.P." contract. F.R.Civ.P. 23 (b) (1) (A) is not satisfied because, as to the two remaining claims, there are no "standards of conduct" sought to be imposed upon the defendant. R. 23 (b) (1) (B) is likewise unsatisfied because adjudications of the individual claims will not be dispositive of the interests of other members not parties to this suit, since the individual claims each depend upon facts peculiar to that individual. For the same reason, R. 23 (b) (3) is not satisfied since the questions of fact peculiar to each plaintiff outweigh any common questions involved.

It likewise is inappropriate to grant plaintiffs' motion for summary judgment as to Counts One through Six, filed September 23, 1974, even as to breach of the provision regarding the separate accounts. While plaintiffs have presented strong evidence as to this breach, defendant State Security has not been heard from on this issue as of this time.

B. Remaining for resolution are the issues surrounding the merger of Great States into State Security in 1968. For the purposes of this memorandum, the issues treated will be those necessary to dispose of Nimmo's and his company's motions to quash or dismiss. These matters are not treated as motions for summary judgment on the merits. Consideration of affidavits and other evidence upon motions to quash does not thereby transform the motions into sum-

mary judgment adjudications. *See* 5 Wright and Miller, *Federal Practice and Procedure* § 1351, at 565 (1969).

Naturally, we look first to determine whether a cause of action has been stated as to any defendant. In assessing this issue, the complaint is weighed heavily in plaintiffs' favor. *Conley v. Gibson*, 355 U.S. 41 (1957). Moreover, to accomplish the broad anti-fraud objectives of the securities acts, the statutes upon which plaintiffs rest their case must be construed "flexibly, not technically and restrictively." *Superintendent of Insurance v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971); *see Herpich v. Wallace*, 430 F.2d 792, 802 (5th Cir. 1970).

Under these principles, whether plaintiffs have stated a cause of action is nevertheless problematical. In essence, it is alleged that Nimmo and his company contrived to sell their stock in Great States to State Security at a premium, with a resultant dilution of the value of Great States' stock in the hands of minority shareholders, including plaintiff Grainger. This was accomplished, as seen in the statement of facts, through the sale of stock to State Security and the subsequent merger of Great States into State Security. Under the wide umbrella of this transaction, plaintiffs also charge violations of the proxy rules.

Plaintiffs sue on their own behalf and on behalf of Great States. Therefore, they have two analytical bases upon which to premise compliance with the doctrine of *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), to the effect that standing to seek redress for violations of Rule 10b-5 requires a "purchase" or a "sale."

In their latest brief, plaintiffs assert that the facts alleged show that Great States' assets were used to purchase Great States' stock. This telescopes the allegations, for the actual facts show that Nimmo sold to State Security. State Security

borrowed funds from a third party to make the purchase. Then Great States was merged into State Security. The only sense in which Great States purchased its securities from Nimmo is that, subsequent to the merger, Great States' assets were subject to the loan obtained to buy Nimmo's stock. However, there is no allegation that the loan was obtained on the strength of the proposed merger, nor is there an allegation that the Great States' assets were subjected to the terms of the loan. Nevertheless, the facts alleged are sufficient to establish a kind of "purchase" by Great States sufficient to warrant a derivative action on its behalf. *Herpich v. Wallace*, 430 F.2d 792, 807-10 (5th Cir. 1970); *cf. Dasho v. Susquehanna Corp.*, 380 F.2d 262, 267 (7th Cir. 1967), *cert. denied sub non, Bard v. Dasho*, 389 U.S. 977 (1967) ["Dasho I"]. The proof as to the cause of action must be directed to whether the scheme complained of was carried on to defraud Great States and whether Great States has been proximately injured thereby. *Herpich, supra*, at 810.

As to the individual plaintiffs, the Graingers, their standing must rest upon their exchange of Great States' stock for State Security's stock. In *S.E.C. v. National Securities, Inc.*, 393 U.S. 453, 467 (1969), the Supreme Court held that an exchange of stock in a merger context was a "purchase." The Court made it clear, however, that its holding was determinative only as to a suit by the S.E.C., and it explicitly declined to address the question for purposes of a private action like the present one. Nevertheless, the extension is a natural one, for by exchanging their shares in Great States for shares in State Security, the plaintiffs have converted their investment from one company to another, precisely the type of situation sought to be covered by the 1934 Act. Moreover, the exchange was the final step in the alleged fraud. Thus, it seems clear that plaintiffs are "purchasers"

within the meaning of the 1934 Act. 15 U.S.C. § 78c (13); *see* Whitaker, *The Birnbaum Doctrine: An Assessment*, 23 Ala. L. Rev. 543, 555 n. 57 (1971).

Once the "purchase" requirement is met, the facts state a cause of action for violation of Rule 10b-5. *Herpich v. Wallace, supra; Dasho I, supra.*[28] It is well to point out that plaintiffs' allegations of fraud in the overall transaction merit full development upon motions for summary judgment. *Herpich* and *Dasho I* are both distinguishable. Both cases involved a similar scheme, but in both the defrauded corporation was the final purchaser of its own over-valued stock; the merger brought into the complaining corporation both the loan *and* the stock. In this case the merger brought in nothing but assets which might be charged with the loan which was already held by the surviving corporation. However, this distinction does not vitiate the plaintiffs' claim since they assert that the net effect was to pay Nimmo and his company a premium,[29] at the expense of his fellow Great States shareholders. This allegation raises fraud regardless of how the sale and merger were structured, so long as material facts were withheld from the plaintiffs. While there may be no fiduciary duty on the part of a majority stockholder to report every offer he gets to his fellow shareholders, there is a duty of disclosure where those shareholders may be charged with the burden of the premium price paid. *Dasho v. Susquehanna Corp.*, 461 F.2d 11, 26 (7th Cir.), *cert. denied*, 408 U.S. 925 (1972) ("Dasho II"). The failure to make such a report may constitute a portion of a larger scheme to defraud the shareholders, regardless

[28]It needs emphasis that this memorandum addresses only the allegations and whether they state a cause of action. No attempt has been made to deal with the statute of limitations or any other issues.

[29]Whether a premium was in fact paid is unclear from the evidence now before the Court, especially in light of Nimmo's assertion that the assets he was required to buy from Great States, in order to consummate the sale, were over-valued in the contract of sale. *See* fn 18, *supra*.

of the right of a majority shareholder to receive a premium for his shares. *Cf. Dasho II, supra,* at 33.

This disposition requires the Court to reach Nimmo's motion to quash.[30] He is correct in arguing that his sale of the Great States stock precludes this Court's assertion of personal jurisdiction over him solely on the basis of the August 28, 1968, proxy statement. *Gould v. Tricon,* 272 F. Supp. 385 (S.D. N.Y. 1967). That he was still technically a member of the board of Great States on August 28, 1968 (since his replacement was not formally chosen until August 30, 1968), does not change the result, since his prior sale of his stock precluded his having any direct hand in the preparation of that proxy statement. Thus, the allegedly false and misleading statements made therein — on which plaintiffs rely heavily — will not support personal jurisdiction over Nimmo.

Nor may this Court hold Nimmo as a "controlling person" under 15 U.S.C. § 77o. Plaintiffs argue strenuously that his receipt of $30,000.00 from State Security as a consultant in the year following the merger and his retention of the power to approve every check issued by Great States in excess of $1,000.00 make him liable for the fraudulent acts of State Security following the sale. To find control, the securities laws require:

> . . . [t]he possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. Rule 405, 1933 Act; Rule 12b-2, 1934 Act.

Neither of the above contractual terms gave Nimmo control over Great States for purposes of the August 28, 1968, proxy statement, particularly in light of the undisputed evidence

[30]For the desirability of the Court's treating documents outside the pleadings, see text at pp. 26-7, *supra.*

that he asked, but was never allowed, to exercise his check approval authority. *See Ayers v. Wilfinbarger*, 491 F.2d 8 (5th Cir. 1974); *United States v. Sherwood*, 175 F. Supp. 480-3 (S.D. N.Y. 1959).

However, Nimmo and his corporation may be required to answer to this Court under plaintiffs' conspiracy count. As it is now before this Court,[31] plaintiffs argue that the August 8, 1968, proxy statement was misleading in that it did not adequately disclose the premium which Nimmo and his company received for sale of control, and that it did not adequately disclose the fact that the ensuing merger would have the effect of charging the Great States minority shareholders with the premium price. While the August 8, 1968, statement does disclose, at page 3, the basic facts from which the above conclusions could be drawn, a question for further development is presented as to whether this disclosure was adequate.

Given this substantial link between the May 10 sales agreement and the September 20 merger, it cannot be said that there is no evidence of a conspiracy here, by which Nimmo agreed to sell his stock in Great States to State Security, with a subsequent merger so that the majority shareholders of Great States would be charged, at least in part, with the burden of paying for the control premium. That Nimmo and his company may have been a part of this conspiracy is sufficiently raised by plaintiffs' documentary evidence regarding the aborted sale and the subsequent lawsuit. Certainly the two defendants may be charged with knowledge of the scheme even if they did not originate it,

[31]Plaintiffs' complaint makes no mention of the August 8, 1968, proxy statement in its substantive allegations; there is a veiled reference to it in the "venue" portion of the complaint. Beginning with their brief of December 30, 1969, however, this proxy statement has assumed added importance until, in their latest brief, plaintiffs aver that the August 8, 1968, proxy statement is materially misleading and in furtherance of the conspiracy. The conspiracy itself is clearly alleged in the complaint.

especially in light of the benefits they derived from it. *Herpich v. Wallace*, 430 F.2d 818, 819 (5th Cir. 1970).[33]

Jurisdiction over Nimmo then may be had under the conspiracy count. *Wyndham Assoc. v. Bintliff*, 398 F.2d 614, 620 (2d Cir. 1968). Commission of any act in furtherance of the conspiracy here likewise makes venue appropriate in the Northern District of Alabama. *Int'l Controls Corp. v. Vesco*, 490 F.2d 1334, 1347 (2d Cir. 1974).

This conclusion makes it unnecessary to reach other contentions raised by the parties.

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[33]Defendants stress the dismissal of the suits against three defendants, situated similarly to Nimmo, in *Dasho II, supra*, at 33. This dismissal must be viewed in light of the plaintiffs' abandonment there of their conspiracy counts. *Id.*, at 16.